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C O N F I D E N T I A L SECTION 01 OF 04 CARACAS 000784

SIPDIS

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ENERGY FOR CDAY, DPUMPHREY, AND ALOCKWOOD

E.O. 12958: DECL: 11/25/2015
TAGS: EPET ENRG EINV VE
SUBJECT: LOOMING OSA DEADLINE INCREASES UNCERTAINTY

REF: A. CARACAS 00394

¶B. CARACAS 00065
¶C. 2005 CARACAS 3758

Classified By: Economic Counselor Andrew N. Bowen for Reason 1.4 (D)

¶1. (C) SUMMARY: The BRV has stated that companies with Operating Service Agreements (OSA) must sign MOUs which commit them to sign joint venture agreements by April 1. Key issues still remain unresolved and it appears companies would waive rights if they signed the MOU. The BRV has stated it will take control of fields on April 1 if the OSA companies do not sign the MOU. A number of contacts believe that the BRV will carry out its threat. OSA companies stand to lose substantial portions of their acreage as a result of the transition. Production continues to decrease in OSA fields and OSA companies did not carry out development drilling or workover activities in February due to uncertainty arising from the transition. It is not clear if PDVSA will adequately fund investment in the OSA fields following the transition to joint ventures. END SUMMARY

NOT AN APRIL FOOLS DAY JOKE

¶2. (C) The BRV has stated that companies with OSAs must sign MOUs that will commit them to sign joint venture agreements that comply with the joint venture framework that is currently before the National Assembly (Reftel A). Since the framework before the National Assembly is quite general, key MOU terms such as valuation are still under negotiation. In addition, a prominent energy attorney told Petroleum Attach and visiting Washington energy analyst she believes companies would waive their rights to arbitration if they sign the MOU.

¶3. (C) Energy Vice Minister Bernard Mommer and Venezuelan Petroleum Corporation (CVP) President Eulogio Del Pino presented Harvest Natural Resources on March 20 with a one and a half page MOU that contained three basic points: the Harvest OSA officially ceased to exist; an outline of the ownership of the new joint venture and a definition of its

property; and a provision for a voucher for future investment. The amount of the voucher was based on the difference between the value of Harvest's investment in its OSA and the value of its share in the new joint venture. The voucher can only be used for future investment. Harvest rejected the proposal on the grounds that the value of its share in the joint venture was too small. Harvest executives stated the proposal was so poor that they did not submit it to the Harvest board of directors. The executives stated they needed time to negotiate a decent valuation of their OSA as well as a rationale conversion process.

¶4. (C) Both the Harvest executives and Luis Prado (strictly protect), Shell's Exploration and Production Vice President, told Petatt and the visiting analyst that the BRV has gone to great lengths to reduce the value of the OSAs. According to Prado, the BRV has sent a large number of auditors to the OSA fields since last April. Energy Minister Ramirez was quoted in the press as stating there are 150 auditors currently examining the OSAs. According to Prado, the auditors' mandate is to reduce the value of future OSA production and the OSAs themselves. Shell's position, which appears to gibe with most of the other companies, is that OSA's value should be based on future business plans. The BRV, on the other hand, does not look at the future but rather focuses on declining production figures. In addition, it argues that the value of the OSA contracts is zero since they are illegal. Harvest executives claimed the BRV bleeds the OSA assets and then focuses on declining production when in valuation negotiations.

¶5. (C) The obvious question is what happens on April 1 if a company has not signed an MOU. According to Harvest

executives, the OSAs will cease to exist on that date and the BRV will expropriate the fields. The executive transition committees (CETEM) that are currently overseeing the OSAs are preparing to take over the fields and operate them. It appears that the BRV believes the companies' employees will continue working under the CETEMs. Shell Venezuela President Sean Rooney (strictly protect) also told Petatt and the energy analyst on March 22 that he believes the BRV will expropriate fields if companies do not sign the MOU. The BRV has also done what it can to further this belief. Energy Minister Rafael Ramirez was quoted in the Venezuelan press as telling the National Assembly on March 23 that article 22 of the Venezuelan constitution authorizes the expropriation of OSA fields or their migration to joint ventures. He said President Chavez prefers migration to expropriation. In addition, the general framework documents that the National Assembly is reviewing clearly states the BRV was prepared to expropriate the Quiamare-La Ceiba field in January if a transition agreement had not been signed for the field (Reftel B).

¶6. (C) Not all companies are pessimistic about the MOU. Rooney stated he was confident that his firm would sign by April 1. He stated negotiations on most of the main points were almost complete. Clancy Cottman, CFO for Vinccler Oil & Gas, a Venezuelan company, also told Petatt and the energy analyst on March 17 that he was confident his company would sign an MOU by April 1. (NOTE: Cottman cheerfully told Petatt on March 7 that his company had almost completed its MOU negotiations. The first thing that he mentioned to Petatt during the March 17 meeting was that the BRV had backtracked on several key points. END NOTE) Giancarlo Ariza (strictly protect), general manager of Hocol, told Pettatt and energy analyst on March 14 that he believes the BRV will be satisfied if 20 to 30% of the companies sign the MOU in time. Ariza admitted that he is not sure if the BRV will really push the companies after April 1 or merely allow the status quo to continue.

¶7. (C) Several contacts have stated they believed Petrobras would be one of the first companies to sign and that once one

or two key companies signed other companies would quickly fall in line. Ariza stated that Petrobras officials told him they would be among the first to sign. Ariza believes it is possible because Petrobras has benefited in the past from a number of government to government deals. According to the minutes of the March 2006 monthly exploration luncheon (strictly protect) Petrobras is negotiating the joint venture agreement in Brazil and will definitely migrate. It is placing its emphasis on additional fields and projects in the Faja and Mariscal Sucre. Petrobras has agreed to a 40% stake in its joint ventures without additional acreage.

JOINT VENTURE FRAMEWORK

¶8. (C) As noted in Reftel A, basic issues such as labor, valuation, foreign currency payments, and operational control issues are still under negotiation. However, the joint venture bylaws framework documents that were presented to the National Assembly on March 15 do clarify a number of points. The framework clearly establishes a "fiscal floor" which states that the BRV will receive at a minimum 50% of the gross revenues of the joint ventures. Thus, if royalties and taxes (50% income tax, 30% royalty, a 3.3% royalty for municipalities, and a 1% tax on gross income for social projects) do not reach an amount equal to 50% of gross revenues, the joint ventures must pay the difference to the BRV. In addition, the majority shareholder (CVP, the PDVSA subsidiary that handles relations with foreign companies) will have the power to make all operational decisions including the approval of work projects and annual budgets provided that they are in agreement with the joint venture's initial business plan. Minority shareholder protection will come in the form of a qualified majority requirement for

changes in the joint venture's charter and initial business plan; the merger, dissolution or liquidation of the joint venture; changes in dividend policies; changes the terms of the sales contract, and the selection of outside auditors. However, any transfer or change in shareholders must be approved by the Energy Ministry and any change in the corporate structure must be approved by the National Assembly. In addition, the joint venture contracts will not contain international arbitration clauses.

¶9. (C) The joint ventures must sell all of their production to PDVSA, which in turn is free to sell the production to whomever it wishes. Payment to the joint ventures will be made in dollars at market prices. The National Assembly will amend Article 57 of the Organic Hydrocarbon Law in order to permit the joint ventures to sell their production to a 100% state-owned entity. Under the present law, they would not be permitted to sell their production.

¶10. (C) OSA companies will also see a tremendous reduction in their acreage. In a March 23 presentation to the National Assembly, Energy Minister Ramirez was quoted by the media as saying that the OSA fields' acreage will be reduced from 40,000 square kilometers to 14,500 kilometers. The average OSA field was 1,398 square kilometers. According to the exploration luncheon minutes, the joint ventures' acreage will only contain developed areas. No exploratory areas will be available to them. (COMMENT: Exceptions may be made for Venezuelan companies. Cottman told Pettatt and energy analyst that his company was offered an additional field as part of the OSA migration. He described the field as having a history of labor problems. END COMMENT)

PRODUCTION AND FUTURE INVESTMENT

¶11. (C) According to the exploratory luncheon notes, average production in OSA fields in February was 465,156 barrels a day down 1.84% from January. Production fell 1.97% in eastern Venezuela and 1.72% in western Venezuela.

Production has fallen 7.8% from July 2005 to February 2006, the equivalent of 37,600 barrels per day. In addition, OSA operators are not carrying out development drilling or workover activities due to uncertainties arising from the migration process.

¶12. (C) A number of companies told Petatt and energy analyst that they were "cherry picking" OSA employees and sending them out of Venezuela. It is not clear how many employees in total have been or will be moved. It is also not clear what impact this will have on the OSA fields' operations. Shell's Prado told us that labor issues are the most important issue for Shell and that it is trying to get the issues on the table. It was not clear if employees will become employees of the joint ventures or merely be seconded to them. Managers from several companies stressed to us that they will not force their companies to become joint venture company employees. Ramirez is quoted as telling the National Assembly that workers would be absorbed by the joint ventures. Newspaper reports on the fate of managers and administrative staff differ. One paper claimed managers may not transfer to the joint ventures because their duties would be duplicated by PDVSA staff. Another paper claimed they would have be vetted first. The exploration luncheon minutes state Mommer and Del Pino told Inelectra executives that all personnel would enter a transition period on April 1 until they had been "screened" by CVP. (COMMENT: It is not clear if personnel that signed the recall referendum will be allowed to work in the joint ventures. At the beginning of the process, it was clear that former PDVSA strikers would not be given jobs in the joint ventures. However, recent comments by BRV and PDVSA officials seem to indicate that employees who signed the recall referendum will also be barred from working in the joint ventures. END COMMENT)

¶13. (C) It is also not clear how many companies will ask to be cashed out rather than continue with the migration process. It was publicly reported in February that PDVSA would assume control of three fields: Guarico Oriental (Teikoku), Guarico Occidental (Repsol), and Pedernales (Perenco). However, according to the exploration luncheon minutes, both Teikoku and Perenco denied returning their blocks. Vinccler announced on March 21 that it purchased West Falcon Samson, which has a 100% interest in the West Falcon OSA. The effective date of the acquisition is October ¶1. The West Falcon assets will form part of Vinccler's joint venture. As noted above, Vinccler appears to be in a favored position due to the fact that it is a Venezuelan company.

COMMENT

¶14. (C) Given the lack of clarity regarding valuation and labor issues among others, we expect to see a continued decline in production from the OSA fields. Contacts repeatedly expressed concern that PDVSA will not invest sufficiently in the fields once it assumes control after the migration. Since most of the fields are marginal, PDVSA may well be tempted to move personnel and resources to fields that it views as more productive. Given the fact that 2006 is an election year, it is also quite possible that PDVSA management's attention will be focused on politics and social programs rather than investment program. It is also not clear the oil companies will want to pour more money into fields in which they have a minority share and no chance of expanding their interests. One executive dismissed the joint ventures as "opportunities to spend money".

¶15. (C) As is the case with industry insiders, we have no idea what will happen on April 1. It is quite likely that the OSA's will cease to exist on that date. However, there does not appear to be anything concrete to take their places. As one executive plaintively asked, "Who assumes responsibility?". As reported in Reftel C, the answer does

not appear to be the CETEM.
BROWNFIELD